IN THE

Supreme Court of the United States

October Term, 1952

No. 290

ERNEST A. WATSON and M. GLADYS WATSON,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

BRIEF FOR THE PETITIONER.

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Opinions Below.

The opinion of the Tax Court [R. 19-50] and the dissenting opinion [R. 50-55] are reported at 15 T. C. 800. The opinion of the Court of Appeals [R. 132-137] is reported at 197 F. 2d 56.

Jurisdiction.

The judgment of the Court of Appeals [R. 138] was entered on May 29, 1952. The petition for a writ of certiorari was filed on August 25, 1952, and was granted on December 8, 1952. The jurisdiction of this Court is invoked under 28 United States Code, Section 1254. (See also 26 U. S. C., Sec. 1141.)

Questions Presented.

The principal issue is: Whether immature, unsevered fruit upon the trees of an orange grove, which had been held and operated for a number of years by a farmer taxpayer, and was sold for a lump sum, unallocated consideration, was part of the real property used in the taxpayer's trade or business within the purview of Section 117(j) of the Internal Revenue Code, or was it property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

A second issue is: Whether the holding period for such property was a period in excess of six months. As an alternative ground for its decision the Court of Appeals for the Ninth Circuit stated that the holding period of the immature fruit began on the date it became the intention of the parties to sell the grove as a unit, and that therefore the property had been held only from May to September, less than six months. [R. 135, 136.]

Statute Involved.

The applicable provisions of Section 117 of the Internal Revenue Code, 26 United States Code, Section 117, provided as of the year 1944, the year involved in this case:

"INTERNAL REVENUE CODE:

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) [as amended by Section 115(b), Revenue Act of 1941, c. 412, 55 Stat. 687, and Section

151(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Definitions.*—As used in this chapter—

(1) *Capital Assets.*—The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), or an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, or real property used in the trade or business of the taxpayer;

* * * * * * * *

(j) [as added by Section 151(b), Revenue Act of 1942, *supra*, and amended by Section 127(b), Revenue Act of 1943, c. 63, 58 Stat. 21] *Gains and Losses From Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.*—

(1) *Definition of Property Used in the Trade or Business.*—For the purposes of this subsection, the term 'property used' in the trade or business' means property used in the trade or business, of a character which is subject to the allowance for

depreciation provided in section 23(l), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Such term also includes timber with respect to which subsection (k)(1) or (2) is applicable.

(2) *General Rule.*—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from the sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For the purposes of this paragraph:

(A) In determining under this paragraph whether gains exceed losses, the gains and losses described therein shall be included only if and to the extent taken into account in computing net income, except that subsections (b) and (d) shall not apply.

(B) Losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion."

Statement.

The taxpayer,* M. Gladys Watson, one of the petitioners herein, and her two brothers, W. Todd Dofflemyer and Lewis L. Dofflemyer, each owned an undivided one-third interest in a 115-acre tract of land (known as the Dofflemyer Grove), consisting of a 110-acre navel orange grove and a 5-acre peach orchard, situated near Exeter, Tulare County, California. [R. 57, 75.] The taxpayer and her co-owners had acquired the property on December 31, 1941, upon dissolution of a family corporation. Taxpayer's brothers had supervised and managed the grove since the year 1912 or 1913. From and after January 1, 1942, the three co-owners had operated the property under a partnership agreement. [R. 20, 21, 74.]

In May, 1944, taxpayer and her brothers listed the Dofflemyer Grove and an 80-acre vineyard with a packing house on it with H. C. Balaam, a local real estate agent. The sale price set was a lump sum for both properties of $329,100.00. The real estate broker secured an offer of $132,000.00 for the vineyard property. Thereupon taxpayer and her brothers withdrew the vineyard from sale and agreed that the asking price for the grove, 5-acre peach orchard, and equipment should be $197,100.00, or the difference between the asking price for all

*The taxpayers are husband and wife, who filed a joint return. Since the interest in the property sold was owned by the wife, she shall be referred to as the taxpayer.

the properties and the amount of the offer for the vineyard property. [R. 21, 89, 90.] Balaam secured a purchaser for the property, one J. W. C. Pogue, of Exeter, California. On August 10, 1944, an escrow agreement was entered into with Pogue, which provided for sale of the Dofflemyer Grove, the peach orchard and equipment to him at the original asking price of $197,100.00. Pursuant to this agreement $10,000.00 was paid on August 10, 1944, and the balance of the purchase price was paid in cash and the deed to the property given on September 1, 1944. The escrow agreement treated the sale in its entirety as a sale of real property and made no allocation of the sale price to equipment, immature fruit, trees or land. The original agreement required the seller to furnish a policy of title insurance in the amount of $197,100.00. Documentary stamps which are required in the sale of real property were attached to the deed in the amount of $217.25, representing a value based upon the entire consideration paid for the property, that is, 55 cents for each $500.00 or fraction thereof. [R. 22, 78; Ex. 5.]

At the time of the contract of sale the orange trees had upon them immature fruit which would not begin to mature and be picked for a period of at least three months. [R. 30, 81-84, 113.] The agreement made no mention of the immature crop of oranges. Unknown to the sellers, the buyer, Pogue (for income tax purposes), made an allocation of his purchase price, wherein he allocated $120,000.00 to the immature crop and the balance of $77,100.00 to the land, trees, irrigation system, improvements and equipment upon the property. [R. 30.]

At the time of the sale there were 11,566 trees on the 110-acre grove of navel oranges and 496 trees on the

5 acres of peach orchard. The orange grove was planted about 1896. It was one of the best groves in the Exeter area. The soil was well suited for citrus trees and the grove had sufficient water available for irrigation. The taxpayer and her brothers followed excellent farming methods and practices and the annual per acre production from the grove was about twice the average per acre production for Tulare County. [R. 24.] The cost of cultivating the grove from January 1, 1944, to the date of sale was $16,020.54 and was taken as a deduction by the operating partnership in its return of income for 1944. [R. 29.]

Navel oranges bloom in the spring and from the blooms small fruit forms on the trees. During May and June, and even later, but principally during June, a considerable portion of the small fruit drops from the trees. After this has occurred, usually around the first part of July in the Exeter area, the orange crop is said to become "set," that is, ordinarily it will thereafter continue to adhere to the tree. The fruit begins to mature in the latter part of November and the major portion of it is picked in December and January, only 6 per cent of the fruit is picked in November and none prior to that time. [R. 26, 81-84, 113.] During the year 1944 there was in effect in the Exeter area the "prorate" system of picking and marketing oranges, which allowed a grower to pick and ship only a certain percentage of his fruit during each week of an eight or ten week marketing period. [R. 27, 83-84.]

There are a number of scales and pests to which growing navel oranges are subject and these pests, in the year 1943, caused a loss of 2 per cent of the crop on the Dofflemyer Grove. [R. 26.] However, the most damaging element to an orange crop in the Exeter area is frost.

Ordinarily the frost period exists from December 10 to January 15 or 20. The Dofflemyer Grove received some protection from freezing weather as it was equipped with wind machines and other protective devices. However, certain years have severe freezes, against which protective devices are ineffective. These severe freezes occur on an average of every 10 years. There was no frost damage to the navel orange crop in the Exeter area during the frost period of 1944-1945. However, during the 1948-1949 period the Exeter area experienced a severe freeze. That season Pogue lost all of the oranges upon 25 acres of the Dofflemyer Grove which still remained on the trees at the time of the freeze. [R. 27, 28.] During the year 1944 there was no buying of fruit on the trees because the cash buyers, as they were called, ordinarily bought oranges for a particular market at a particular time and they could not achieve this under the prorate system. Taxpayer and her brothers were farmers and fruit growers and were in the business of producing and selling picked, ripe oranges (personalty). They were not in the business of selling orange groves; neither was it their business to sell immature fruit on the trees and they had never made such a sale prior to the sale here in question. [R. 74, 75, 94, 95, 122, 123.]

In operating the grove they followed the procedure of selling their oranges through the California Fruit Growers Exchange. This is a marketing organization which sells the pooled fruit of many growers on the eastern markets and remits to each grower his proportionate part of the average selling price received for the pool. More than 95 per cent of the orange crops in the Exeter area are sold through exchanges such as the California Fruit Growers Exchange. [R. 29, 30, 87, 88.]

Taxpayer and her brothers never contemplated selling their immature fruit on the trees in August of the year 1944 or in any other year. [R. 122, 123.] In the joint income tax return of taxpayer and her husband, she reported the sale of her one-third interest in the Dofflemyer Grove at a net gain of $48,819.82, of which 50 per cent, or $24,409.91 was included in their taxable income as a long term capital gain. The Commissioner determined that of the reported net gain of $48,819.82 from the sale, $40,833.33 represented taxpayer's one-third share of the fair market value of the growing crop of oranges on the trees and that such amount constituted ordinary income and not capital gain. [R. 30, 31.] The Tax Court held that of the gain reported by the taxpayer $13,333.33 was allocable to the growing crop on the trees and that the same was taxable as ordinary income. [R. 31.] Two judges dissented. [R. 50-55.] The Court of Appeals for the Ninth Circuit affirmed the decision of the Tax Court. [R. 131-137.]

Specification of Errors.

1. The United States Court of Appeals for the Ninth Circuit erred in holding that the immature fruit on the trees on the date of sale of the orange grove was property held primarily for sale to customers in the ordinary course of trade or business, and in failing to hold that the same was real property within the purview of Section 117(j) of the Internal Revenue Code.

2. The Court further erred in deciding in the alternative that the six-month holding period of the immature fruit commenced when the parties decided to sell the property as a unit, rather than when the property was acquired.

Summary of Argument.

The taxpayer and her brothers were in the business of producing, picking and selling mature oranges. Sales were made through an exchange to eastern buyers. On September 1, 1944, the taxpayer sold her interest in the grove. At the time of sale the trees had upon them green, immature fruit, which would not be ripe or ready for picking until approximately three months thereafter. Except as a part of the real estate the immature fruit had no value. Its sale as picked fruit was prohibited by law. If severed at the date of sale of the grove the green fruit was worthless and would have withered and died.

California law, in line with the general rule, holds an immature, growing crop to be part of the real estate. Title to immature fruit passes to the buyer under a deed to the land, without any mention being made of the fruit. The immature fruit, being part of the trees, was part of the real property used in taxpayer's business of producing and selling ripe, picked oranges.

None of the property sold by taxpayer was held by her *primarily* for sale to customers in the *ordinary* course of her trade or business. Taxpayer was not in the business of selling immature fruit on the trees. The sale was a unit sale for a lump sum unallocated consideration of the real estate used in the trade or business of producing and selling mature, picked oranges (personalty).

The holding period of the property sold began on the date of its acquisition in 1941. The holding period of the immature fruit did not begin in May, 1944, at the time the offer was made by the taxpayer to sell the grove as a unit. The property in question was held for more than six months and its sale resulted in capital gain under Section 117(j) of the Internal Revenue Code.

Argument.

The taxpayer and her two brothers each owned an undivided one-third interest in a 115-acre tract of land, known as the Dofflemeyer Grove. On August 10 of the taxable year, the taxpayer and her co-owners entered into a contract for the sale of this property, together with improvements, water rights and the equipment thereon, for a lump sum consideration of $197,100.00. The sellers had acquired the property on December 31, 1941, through liquidation of a family corporation. Deed to the buyer of the property was given on September 1, 1944, pursuant to the agreement of August 10, 1944, which treated the sale in its entirety as a sale of real property and made no allocation of the sale price. At the time of sale the orange trees had immature fruit upon them which had "set" (*i. e.*, reached the stage of adhering firmly to the tree), but which would not be mature and ready for marketing for a minimum of three months. The Tax Court, in its decision, allocated $40,000.00 of the sale price to the immature fruit and held that the same should be taxed as ordinary income in lieu of capital gain. It is taxpayer's contention that the entire gain upon disposition of the grove was capital gain, within the purview of Section 117(j) of the Internal Revenue Code (26 U. S. C. 117(j)) and that the Tax Court and the Court of Appeals for the Ninth Circuit erred in treating any part of the gain as ordinary income.

The issue thus presented is whether the immature, unsevered orange crop is real property used in the trade or business of the taxpayer, or whether the same is real property separate and apart from the land and trees, held by the taxpayer *primarily* for sale to customers in the *ordinary* course of her trade or business, as contended by the

Commissioner. A consideration of the statutory provisions, as applied to the facts of this case, will show that the taxpayer is correct in her contention that it is property falling within the purview of Section 117(j) of the Internal Revenue Code.

As an alternative ground for its decision the Court of Appeals for the Ninth Circuit stated:

> "Assuming this decision to sell the property as a unit changed the character of the holding of the crop, §117(j)(1) is not satisfied, for the crop was not held in the non-business sale character for the six months required by that section."

We will demonstrate that such an interpretation of the statute is clearly erroneous.

I.

A Growing, Immature and Unsevered Crop of Oranges Under the General Rule and Under the Applicable California Law Is Part of the Real Property.

The general rule of the common law is that growing crops form a part of the land to which they are attached and that they follow the title of the land unless there is an express reservation or exception to the contrary. (*Am. Jur.*, Vol. 15, p. 200; *C. J. S.*, Vol. 25, p. 7.) This rule is based upon practical consideration and good reasoning. The case of *McCoy v. Commissioner of Internal Revenue*, 192 F. 2d 486 (C. C. A. 10th), involved the sale of wheat lands having at the date of sale an immature wheat crop upon them. The Court of Appeals for the Tenth Circuit held that the gain on the sale of the immature crop was to be treated as capital gain, as a gain on the sale of real property under Section 117(j).

In commenting upon the nature of growing crops, the opinion of Judge Huxman at page 488, states:

> "* * * In other words, Kansas treats growing crops as a part of the real estate to which they are attached and thus considers such crops as real estate. * * * Growing crops depend for their life upon the real estate of which they are a part. They draw their food and sustenance therefrom. Separate them from the real estate and they cease to exist and die. Except as a part of the real estate, a growing immature crop has no value."

The California courts from the earliest times have held that an immature, unsevered, growing crop of fruit on the trees is a part of the real estate, and, upon conveyance of the land title to the crop passes to the grantee. The decisions of the Supreme Court of California have consistently recognized the peculiar nature of growing crops and have held that they have no independent existence apart from the land to which they are attached and upon which they depend for nutriment. The following California cases support this rule.

Penryn Fruit Co. v. Sherman-Worrell Fruit Co., et al., 142 Cal. 643, 76 Pac. 484;

Huerstal v. Muir, 64 Cal. 450, 2 Pac. 33;

Wilson v. White, 161 Cal. 453, 119 Pac. 895;

Young v. Bank of California (1948), 88 Cal. App. 2d 184, 198 P. 2d 543.

It is a well-settled rule of statutory construction that the natural, ordinary and well-settled meaning of the words used in a statute will be adopted in the absence of a definite indication that Congress intended some other meaning. (*Helvering v. William Flaccus Oak*

Leather Co., 313 U. S. 247; *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364.) The words "real property" in the phrase "real property used in the trade or business" in Section 117(j)(1) clearly were used by Congress in their ordinary and well-settled meaning as defined by the general rule of the common law and the law of California. Consequently, the growing, immature, unsevered crop as well as the trees and the land fell within the purview of Section 117(j) as real property.

II.

The Green, Unsevered, Immature Oranges Were Not and Could Not Be Property Held by the Taxpayer Primarily for Sale to Customers in the Ordinary Course of Her Trade or Business.

It is an axiom of tax law, often quoted, that "taxation is an intensely practical matter." (*Farmers Loan & Trust Co., Executor v. Minnesota*, 280 U. S. 204.) It has repeatedly been held that tax laws deal with actualities and are unconcerned with theoretical considerations. (See Mertens, Law of Federal Income Taxation, Vol. 1, Sec. 5.03.) This rule has been reiterated in the case of *Louise Owen v. Commissioner*, 192 F. 2d 1006 (C. C. A. 5th). That case involved the sale of orange groves with growing fruit on the trees. The majority of the fruit had matured but was not picked. The Court, in its opinion, stated (p. 1008):

> "As in other problems of taxation, the approach here should be factual, not hypothetical."

In making this statement the Court was dealing with the argument of the Commissioner to the effect that had the taxpayer sold the grove to one purchaser and the fruit separately to another purchaser that in such event

she would have realized ordinary income. However, the Court pointed out that taxation follows the facts and that the transaction as it actually occurred furnishes the answer. It was held that taxpayer's ordinary business was selling citrus fruit as personalty, altogether severed from the realty, and that she was not in the business of selling groves. The Court said there was no sale of fruit as personalty, that the constructive severance made by the Commissioner for tax purposes was purely artificial. It was held that the growing fruit was not at the time of the sale property held *primarily* for sale in the *ordinary* course of taxpayer's trade or business.

Similarly, in the instant case the actualities of the sale made by the taxpayer should govern. Taxpayer was in the business of producing and selling picked, ripe oranges (personal property). She marketed her crop through the California Fruit Growers Exchange, which sold the crop to wholesale merchants in the eastern markets. She was not in the business of selling orange groves, nor selling green fruit on the trees. During their entire business experience, taxpayer and her brothers had never made a sale of fruit on the trees and had never sold immature fruit. In 1944, no sales of fruit on the trees, even when the same was mature, were made in the vicinity of Exeter, California, because of the Federal prorate system, then in effect. Also, Lewis L. Dofflemyer, manager of the grove, testified that it was absolutely unheard of to sell oranges on the trees in August, because they were then in such an early stage of development [R. 122, 123].

At the date of the sale, the green, unsevered fruit was simply a part of the real property used in taxpayer's business of growing and selling mature, picked oranges.

It is undisputed that green citrus fruit severed from the trees has no commercial value; it is not inventoriable; its sale to consumers is prevented by law. It is absolutely dependent for its sustenace and support upon the tree of which it is an inseparable part. It differs little from the blossoms. Both represent only the prospect of future income; neither represent a crop which could be separated from the tree and marketed as such. The facts are that at the time the grove was sold taxpayer held no property primarily for sale to customers in the ordinary course of her trade or business. The ripe, picked oranges which would constitute property so held had not come into existence.

The immature crop was subject to hazards of insects, blight, wind and freezing weather, and might never survive to become a mature crop. On an average of once in ten years, the freezing weather in the Exeter area is severe enough to damage extensively or completely destroy an orange crop. The small green fruit increased the value of the grove, since it indicated that income, in the form of a mature, picked crop might be anticipated at a future date. This differs little from the anticipation that the living tree for an indefinite number of years in the future will continue to produce an annual crop, and it is from such anticipation that the orange tree derives all of its value.

It is evident that the sellers were selling an orange grove. They were not attempting to dispose of a crop. They offered the grove for sale through the real estate broker in May. At this time, there was no set crop of oranges upon the trees. [R. 80, 89.] The co-owners never changed the price of the grove quoted to the real estate broker, and it was sold at the original asking price.

It is apparent that they were proposing to sell the grove as such, and attached no particular value to the immature fruit. In their dealings the sellers gave no recognition to the artificial severance of immature crop from trees which the Commissioner has proposed.

It is therefore evident that the trees and the immature crop comprised a single and indivisible whole, as real property used in the taxpayer's trade or business, none of which was held primarily for sale to customers in the ordinary course of her business.

III.

Decisions of the Tax Court and the Courts of Appeal Hold That Natural Products Attached to the Land and Not in Final Salable Form Are a Part of the Capital Investment, and Not Property Held Primarily for Sale to Customers in the Ordinary Course of the Taxpayer's Trade or Business.

The Tax Court and the Courts of Appeal have held that natural products attached to the land and not in final salable form are in their nature part of the capital investment and do not constitute "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

The case of *Butler Consolidated Coal Co.*, 6 T. C. 183, involved a sale of lands containing veins of unmined coal by a taxpayer whose business was the mining and selling of coal. The Tax Court held that the unmined coal should be treated as a capital asset. At page 189 of its opinion the Tax Court said:

> "The petitioner contends that the 'coal in place' in the Erico property was property held by the taxpayer primarily for sale to customers in the ordinary course

of its trade or business.' The business of the petitioner was the mining and sale of coal—not the sale of coal which it had purchased from others, but the sale of coal which it produced itself. Coal in place is a part of the realty. It is a part of the realty as much as any fixtures on the property. The petitioner was not engaged in the business of selling real estate or 'coal in place.' We are of the opinion that the coal in place in the Erico property was not held by the petitioner 'primarily for sale to customers in the ordinary course' of its trade or business. *Cf. Carroll v. Commissioner* (C. C. A., 5th Cir.), 70 F. 2d 806."

Related cases have held the same with respect to a sale of standing timber by a taxpayer engaged in the business of cutting the timber, sawing it into lumber and selling the lumber. (*Carroll v. Commissioner*, 70 F. 2d 806; *Camp Manufacturing Co.*, 3 T. C. 467.) Similarly, an individual owning an oil-producing property and engaged in selling the oil, should he sell the entire property would not be required to treat a portion of his sales price representing the oil reserves in the ground as ordinary income from sale of the oil (that is, from sale of stock in trade). (*I. T. 3693*, 1944 C. B. at page 272.)

As far as taxation is concerned, there is in substance absolutely no difference between the lumberman who owns timberland from which he produces logs which he cuts into boards to sell, the miner who owns coal lands from which he mines coal to sell, the oil man who owns acreage upon which he has producing oil wells, and the orchardist who owns an orange grove with immature oranges on the trees. All own land which produces substances which, when severed from the land, become per-

sonal property, which they then hold for sale in their trade or business. The value of the land to the lumberman depends, among other things, on the amount and kind of timber on it. In the case of the coal mine owner, the value of his land depends on the amount and accessibility of the coal discovered. As to the oil man, the value of his land depends on the amount of oil reserves discovered and the amount which his wells can produce. As to the orchardist, the value of his land depends on the kind of trees in his grove and the anticipation that successive crops will be produced. In all cases there is potential future income to be realized, but only if that product is severed from the land to sell. The lumberman must cut the trees into logs and run them through his sawmill; the coal miner must sever the coal from the vein and bring it to the surface and put in his coal bin; the oil man must pump the oil into his tanks; and the orchardist must pick his oranges when they mature and deliver them to the packing plant to be prepared for market. All produce personalty for sale when it is severed from the ground, which becomes their inventoriable stock in trade. All are in the business of selling personal property. They hold the personal property for sale to customers in the ordinary course of their trade or business only after it is severed from the ground. There is no ordinary income, actual or constructive, to be taxed until it is produced and severed from the land, or at the very earliest in the case of the orchardist, until the fruit attains maturity on the tree and becomes for the first time, farm produce. It is just as logical to tax the oil reserves in the ground as ordinary income in case of sale by the owner of oil property as it is to tax as ordinary income immature

fruit on the trees before the fruit is picked or harvested. The same can be said of the unmined coal in the pit, and the uncut timber in the forest. Why should the orchardist be singled out to pay a tax as ordinary income on unrealized potential income, while the others pay a capital gains tax when their land is sold? There is no reason for such a distinction. The tax on the sale of such real estate falls squarely within the purview of Section 117(j) and should be treated as a sale of a capital asset.

The Court of Appeals for the Tenth Circuit has applied this rule with respect to the sale of agricultural land with an immature, unsevered crop, *McCoy v. Commissioner of Internal Revenue* (1951), 192 F. 2d 486. The holding is summarized in the words of that opinion as follows:

> "* * * McCoy was not engaged in the business of producing and selling immature crops of wheat. His business was that of producing, harvesting and selling mature grain in the ordinary course of business. It follows that no part of the transaction resulting in the sale of this land was an operation carried on in the course of his business of producing, harvesting and selling ripened grain. The sale was a unit sale of a piece of real estate used in his business of producing and selling grain. The real estate in question had been so used in the business for more than six months and the sale resulted in a capital gain."

The facts are analogous to the other real property sales set out above, and the holding, we submit, is unquestionably correct.

IV.

The Fact That Taxpayer Is Permitted to Deduct as Ordinary Expense the Cost of Cultivation and Care of the Grove to the Date of Sale Does Not Confer Any Unique Advantage Upon the Taxpayer; nor Is It a Reason for Denying to Her the Application of Section 117(j) as to the Entire Sale Proceeds.

Counsel for respondent no doubt will argue that since taxpayer and her brothers were permitted to deduct as ordinary expense approximately $16,000.00, being the cost for the care of the grove from January 1, 1944, to September 1, 1944, the immature crop should be segregated and taxed as ordinary income. The deduction of expenses does not give the taxpayer any unusual or unique advantage.

For example, a taxpayer who sells at a profit a truck used for several years in a trucking business is permitted to charge off depreciation and expenses of repair and upkeep made on the truck during the year of sale against his ordinary income, while the gain, if any, is taxed as capital gain. That this construction of Section 117(j) is correct is not questioned.

A similar situation exists with respect to the sale of animals used by a farmer for breeding purposes in his business of producing and selling livestock. It is settled that the farmer may deduct from income all of his ordinary expenses of raising and caring for such breeding animals to the date of sale and that gain upon the sale, assuming such animals to have been held the required period, is long term capital gain. (*United States v. Bennett* (C. C. A. 5, 1951), 186 F. 2d 407.)

Coming to the expenses deducted in the instant case, it is evident that they fall into the same category. The sums expended by the taxpayer were for watering, fertilizing, fumigating, and other items necessary to keep the trees alive and healthy and to maintain the equipment which was sold with the grove. These annual expenses were necessary to keep the orchard going whether it produced a bumper crop or produced no crop at all.

It is evident from the foregoing that the sale of the land and the immature crop did not permit the taxpayer to escape tax, nor is there any suggestion that she was taking advantage of a loophole in the law. Taxpayer reported her entire gain upon the sale and has paid tax thereon at the alternative rate of 25 per cent.

V.

The Ruling of the Commissioner in 1946 Requiring an Allocation Between the Orange Grove and the Immature Fruit on the Trees Is a Misapplication of the Fragmentation Theory of Williams v. McGowan, 152 F. 2d 570.

For many, many years after the inception of the income tax law, the Commissioner never required that a farmer should segregate the immature crop from the land upon its sale, and treat the portion of the sale proceeds to be assigned to the crop as ordinary income. Indeed his prior rulings indicated that such an allocation could not be made. In *I. T. 1368*, I-1 C. B. 72, he stated that immature crops were not inventoriable property; the reason given is that the value and amount of such crops cannot be determined. This, we think, is in recognition of the fact that immature crops in themselves represent only pos-

sible future income. It was not until the year 1946, that *I. T. 3815*, 1946-2 C. B. 30 was issued by the Commissioner. This ruling for the first time proposed to treat a part of the sale proceeds, representing some value of the growing crop, as ordinary income.

Although this ruling does not so state, it is apparent that it was inspired by the decision of the Court of Appeals for the Second Circuit in the case of *Williams v. McGowan*, 152 F. 2d 570, decided December 20, 1945. That case involved the sale of an entire business conducted as a sole proprietorship. While admitting that in the case of sale of a partnership interest, the sale would fall within the purview of the capital gain and loss provisions, irrespective of the nature of the assets comprising the partnership, the Court held that a different rule applied in case of the sale of a sole proprietorship business. In this latter situation, the majority held that the business must be comminuted into its fragments, and each fragment separately matched against the definition contained in Section 117. Judge Frank wrote a vigorous dissenting opinion in which he pointed out that the carving up of a going business into its parts was a purely artificial segregation, not recognized by the parties and not intended by Congress in enacting the 1942 Amendment to Section 117.

The incongruity of treatment between the sale of partnership and sole proprietorship interests, we believe, casts doubt upon the correctness of the holding in *Williams v. McGowan*, 152 F. 2d 570. Irrespective of its correctness, however, when applied to sale of a mercantile business with merchandise inventory as a principal asset, the ruling of the Commissioner that a similar segrega-

tion should be made between land, trees and growing crop, is an absolutely unwarranted extension of that doctrine.

The analogy of the inventory comminuted as a fragment of the business sold in the case of *Williams v. McGowan, supra,* is applicable to the picked mature oranges of the orange grower. However, this analogy loses its force and validity when it is extended to include a growing crop which the law and practical reasoning both say is no more than part of the realty.

The green fruit represents only the prospect of future income. It does not differ from the anticipation that the grove will produce a large and profitable crop next year and in the years to come. The entire value of the orange trees at the date of sale is in the prospect of future income to be realized from the crop anticipated for the year 1944 and for subsequent years. If the prospect of income represented by the immature crop on the trees is to be segregated and taxed as ordinary income, does not the same logic require that the blossoms on the tree should be segregated and taxed as ordinary income, in the event the sale of a grove is made in April or May? Since the potential crops for 1945 and subsequent years are also present in the tree at the time of sale, represented by the leaves, bark, sap, and other parts of the living organism, should they not also be segregated and taxed? The fact that a producing piece of property is expected to yield ordinary income periodically in the future has never been the basis of taxing a portion of the sale proceeds of such property as ordinary income.

VI.

The Court of Appeals for the Ninth Circuit Misinterprets Section 117 of the Internal Revenue Code by Narrowly Construing the Term Capital Assets When It Is Evident That a Broad Construction Was Intended by Congress.

The Court of Appeals for the Ninth Circuit states that its conclusion is re-enforced because the purpose of the capital gain sections is to tax at special rates, rather than at ordinary rates, a realization of values which have accumulated over a long period of time, citing its previous decision, *Rollingwood v. Commissioner*, 190 F. 2d 263. Prior to 1942 Section 117 did provide that the holding period, in order to realize a long term capital gain, taxable at 50 per cent, was a period of two years, and to realize an intermediate long term capital gain taxable at 66⅔ per cent was a period of eighteen months. If this had been the law in 1944, there would be some basis to support the statement of the Ninth Circuit Court. However, the Revenue Act of 1942 reduced the two-year and eighteen-month holding periods to a holding period of only six months. This was done at the same time that Section 117(j) was added to the Internal Revenue Code. The law as it now reads could not have been intended to apply solely to a realization of values which have accumulated over a long period of time. The statute specifically states that a long term capital gain is realized on the sale of a capital asset held for more than six months.

The lowering of the holding period to six months was to encourage sales of capital assets and thereby increase

the revenues. The Senate Finance Committee Report on the 1942 Revenue Act states:

> "Your committee believes that the lowering of the holding period will have the effect of encouraging the realization of capital gains and thereby result in added revenue to the Treasury. * * *" (Senate Report 1631, 77th Cong., 2nd Sess., 1942-2 C. B. p. 545.)

It should be noted that the ruling of the Ninth Circuit in the instant case would seriously deter sales of orange groves, since the seller could never be sure of the amount of his tax liability resulting from such sales where an immature crop is on the trees. This would result from the difficulty of determining the amount to be allocated to the growing fruit. In the instant case the expert opinions expressed at the trial as to the value of the immature crop varied from a low of $4,000.00 to a high of $120,000.00. [R. 49.] Although the Commissioner in his deficiency notice contended for a value of $122,500.00 for the crop, he has acquiesced in the Tax Court decision which found a value of $40,000.00. [R. 50, 1951-1 C. B. 3.] Since the apparent purpose of Congress was the desire to facilitate sales, a holding which has the opposite effect is obviously in error.

Congress has consistently manifested its intent that the term "capital assets" be broadly construed and the exceptions to the definition narrowly construed.

Subsection 117(a)(1) defines "capital assets," excluding therefrom "property held by the taxpayer primarily for sale to *customers* in the *ordinary* course of his trade or business." This language was carried over into Section 117(j). Originally, the exclusion appeared

without the underlined words which were added by the Revenue Act of 1934. The Committee Reports on the Revenue Act of 1934 make it clear that the purpose of the amendment was to narrow the exclusions as they previously existed, thereby giving the broadest possible scope to the term "capital assets." The amendment was made during the depression years and its evident purpose was to prevent tax avoidance arising from offsetting of losses on sales of property against ordinary income, by bringing more losses within the scope of capital loss limitations. The following excerpt from the Committee Reports reprinted in Cumulative Bulletin, 1939-1 Part 2 show that the interpretation referred to above was intended (Senate Report, p. 595):

> "Second, the definition of capital assets has been slightly revised to prevent tax avoidance by excluding from the category of a capital asset 'property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business,' instead of merely 'property held by the taxpayer primarily for sale in the course of his trade or business.'"

See also the Conference Report at page 632 which indicates that as a result of the amendment it would be impossible to contend that a stock speculator trading on his own account is not subject to the provisions of Section 117.

Likewise the Tax Court recognized that such a result was intended. In *Camp Manufacturing Co.*, 3 T. C. 467, 474, it was stated:

> "* * * The words emphasized above ['to customers' and 'ordinary'] were added to section 117(a)(1)

by the Revenue Act of 1934. It is apparent that their inclusion narrows the scope of the exception as it previously existed. * * *"

It is clear that Congress intended a broad construction of the definition of "capital assets" rather than the narrow definition adopted by the Court of Appeals for the Ninth Circuit in the instant case.

Further insight into the Congressional intent as to the meaning of the term "capital assets" is to be gathered from Section 323 of the Revenue Act of 1951. This section expressly provides for capital gain treatment in the case of an unharvested crop, if the crop and land are sold together.

The Committee Report (Senate Report No. 781, Eighty-second Congress, First Session, printed at 1951-2 Cumulative Bulletin, p. 458 at p. 492) of the Senate Finance Committee, we believe, clearly shows the Congressional understanding of the law that such transactions did not fall partially beyond the scope of Section 117(j) of the Internal Revenue Code. After reciting the conflict which has arisen in the case of the sale of agricultural land with an unsevered, immature crop, the report contains the following significant language:

"Your committee believes that sales of land together with growing crops or fruit are not such transactions as occur in the ordinary course of business and should thus result in capital gains rather than in ordinary income. * * *"

This statement of the Committee expresses unequivocally its opinion that sales of land with growing crops

business. The Committee Report would seem to say that the 1951 Revenue Act did not create a new status for unharvested crops; it merely clarified the intent of Congress that Section 117(j) should apply. The Court of Appeals for the Ninth Circuit chose to find the intent of Congress from the Committee Report that the 1951 amendment was a change of law, rather than a clarification. It based this finding upon the grounds that the amendment was not expressly made retroactive and that the Committee Report referred to a loss of annual revenue resulting from the amendment. The failure of Congress to make the 1951 amendment retroactive, when considered in the light of the above-quoted statement of the Committee, appears to mean no more than that Congress saw no necessity of doing so. Prior years are taken care of by the statement of the Committee that such sales are not in the ordinary course of business.

Respecting the annual loss of revenue referred to, it would appear that this is a loss in revenue resulting from Congress making clear its intention that Section 117(j) always was applicable to unharvested crops, sold with the land to which they are affixed. At page 488 (1951-2 C. B. p. 488) the Committee Report deals with the 1951 amendment respecting gains from the sale of livestock held for draft, breeding or dairy purposes. This section was expressly made retroactive. However, the report contains a similar statement that the revenue loss under this provision is expected to be $15 million in a full year of operation. It is evident that the statements as to revenue losses refer to past as well as future years and do not indicate that a change in the law, rather than clarification, was being effected.

VII.

The Holding Period of the Immature Crop, as an Indivisible Part of the Trees to Which It Was Attached, Began on the Date of Acquisition of the Grove, and Not at the Time It Was Decided to List the Property for a Unit Sale as Stated by the Ninth Circuit.

In its opinion the Court of Appeals, Ninth Circuit, assumes that the intent to sell the grove as a unit made the holding of the orchard and crop a holding for a sale not in the ordinary course of any business of the taxpayer. It goes on to state that in such event this property would not have been held for the required six months, since the decision to sell was made in April or May and the sale was completed on September first of the same year. The Court errs in stating that the holding period began with the decision to list the grove as a whole with a real estate broker. There was no conversion of the property on that date nor any acquisition from which a holding period would begin to run. The basis of the property was unaffected. Respecting the time at which the holding period of a particular piece of property begins to run, this Honorable Court, in the case of *McFeely v. Commissioner of Internal Revenue*, 296 U. S. 105, stated at page 107:

> "In common understanding to hold property is to own it. In order to own or hold one must acquire. The date of acquisition is, then, that from which to compute the duration of ownership or the length of holding. * * *"

The taxpayer here held the orange grove from January 1, 1942, to September 1, 1944, a period in excess of six months. [R. 20, 22.] The Commissioner's own witness, Pogue, testified that he considered that the new crop started off in December of one year or January of the second year and that by the first of September there had been eight months toward the development of another crop. [R. 111.] Consequently, whether it is considered that the property sold was acquired on January 1, 1942, or only at the starting of the new crop, the period of holding in either event was in excess of six months. We believe that the correct rule is that the holding period runs from the date of acquisition of the land and trees since the immature crop is an inseparable part of the land prior to maturity and represents only the prospect of or potential future income.

It is submitted that the courts should look at the transaction which actually took place in determining the nature of the sale. However, it is an unwarranted addition to the law to hold that the holding period for a sale not in the ordinary course of the taxpayer's business begins only on the date that an intention is formed to make such a sale if a buyer could be found. The incidents of tax laws turn upon more substantial ground than this.

Conclusion.

The petitioner, M. Gladys Watson, and her brothers were engaged in the occupation of producing and selling mature ripe oranges. They were not in the business of

selling real estate. The immature, unsevered fruit is a part of the real estate. The sale by petitioner and her brothers of the grove with immature, unsevered fruit on the trees does not represent the sale of property held primarily for sale to customers in the ordinary course of trade or business. The holding period of the immature fruit as a part of the realty began on the date the grove was acquired in 1941, and therefore was a period in excess of six months. The entire transaction falls within the purview of Section 117(j) of the Internal Revenue Code, and the gain should be treated as a capital gain. The decision of the Court of Appeals for the Ninth Circuit should be reversed.

Dated January 12, 1953.

Respectfully submitted,

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Service of the within and receipt of a copy thereof is hereby admitted this.....day of January, A. D. 1953.

1-16-53—70